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FISCAL POLICIES MANUAL

GENERAL ACCOUNTING: EXPENDITURES CAPITALIZED LEASES

PREFACE

State agencies may enter into long-term lease agreements for assets where substantially all the risks and benefits of ownership are assumed by the agency. Because such leases are viewed, for the most part, as installment purchases of property rather than rental of property, they should be classified as a capital lease. Accounting for such leases requires adherence to materiality thresholds, proper separation of principal and interest, and the periodic recording of depreciation, if applicable.

The National Council on Governmental Accounting Statement (NCGAS), Pronouncement 5, paragraph 24 states that if the lease is with another state agency or entity that is part of the governmental unit's entity for financial reporting purposes, then the criteria of the Financial Accounting Standards Board's (FASB) Statement 13 do not apply. Therefore, the lessee does not record an asset and a liability. Also, instead of recording interest and principal, the lessee records the payment as an interfund operating expenditure.

DEFINITIONS

Lease: The NCGAS Pronouncement 5 refers to FASB's statement 13 as a guideline for accounting and financial reporting for lease agreements. FASB defines a lease as "an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time. It includes agreements that, although not specifically identified as leases, meet the above definition."

It is not always easy to tell the difference between a capital lease and a purchase agreement. The following are some ways to identify a lease:

1. On a lease, the lessee's name will not be on the title until the end of the lease (if at that time the lessee becomes owner). On a loan, the title will reflect the purchaser as owner and the bank (or creditor) as lender at the beginning of the agreement period.
2. A lease more closely resembles a rent (or a rent with an option to buy) rather than a purchase.
3. A lease conveys less than total interest in the property.
4. A lease will often contain information on the rights and obligations of the lessee (e.g., an additional fee after so much use).

Capital Lease: If, at its inception, a lease meets one or more of the following criteria, the lessee should classify it as a capital lease:

1. The lease transfers ownership of the property to the lessee by the end of the lease term.
2. The lease contains a bargain purchase option.
3. The lease term is equal to 75 percent or more of the estimated economic life of the leased property. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, these criteria shall not be used for purposes of classifying the lease.
4. The present value, at the beginning of the lease term, of the minimum lease payments (excluding that portion of the payments representing executory costs) to be paid by the lessor, including any profit thereon, equals or exceeds 90 percent of the fair value of the leased property to the lessor at the inception of the lease. However, if the beginning of the lease falls within the last 25 percent of the total estimated economic life of the lease property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.

Operating Lease: A lease that meets the FASB's Statement 13 definition, but does not meet any of the four capital lease criteria. The lessee debits rental expenditure and credits cash.

Bargain Purchase Option - An option giving the lessee the opportunity to purchase the property at substantially below the expected fair value at the date the option may be exercised. It offers a price that seems so favorable at the date of the lease agreement that the option is reasonably certain to be exercised.

Guaranteed Residual Value - A guaranteed amount that the lessee assures the lessor will recover at the end of the lease term. Lessors often insert guaranteed residual value clauses to minimize risk. A guaranteed residual value and bargain purchase option are mutually exclusive; only one of the two can be in the same lease agreement (or neither will be in the lease agreement).

Future Minimum Lease Payments - The payments the lessee is obligated to make, or can be required to make. This amount includes the bargain purchase price or a guaranteed residual value, if applicable.

Executory Costs – Asset “ownership-type costs” such as insurance, taxes, or maintenance expense. If a portion of a capital lease payment represents executory costs, then this portion of the payment should be excluded when figuring the present value of lease payments.

Present Value – Current worth of future sums of money. For help calculating this, see the Resources below or contact the State Controller's Office, Bureau of Reporting and Review.

Fair Market Value – amount that could be received on the sale of an asset when willing and financially capable buyers and sellers exist and there are no unusual circumstances such as liquidation, shortages, and emergencies.

POLICY

All leases that 1) meet one of the four capital lease criteria and 2) have a present value of **\$5,000 or more** (based on either the fair market value or present value of minimum lease payments, whichever is less) shall be reported as a capital lease. The asset and corresponding liability will be reflected in the financial statements of the State.

FISCAL IMPACT

In accordance with the FASB's Statement 13 paragraph 10, the liabilities of the State will be increased by the Fair Market Value or the present value of future minimum lease payments (excluding portions representing executory costs such as insurance, maintenance, and taxes) as of the inception date of the lease, whichever is less. The assets of the state will be increased by a corresponding amount.

ADMINISTRATIVE PROCEDURES

The principal portion of capitalized leases will be recorded as an expense to the budget category/STARS object capital outlay.

Subobjects for capital leases include: 6905/Computer, 6910/Machinery and Equipment, 6915/Office Equipment, 6920/Vehicles, 6930/Land, 6940/Buildings, 6950/Improvements Other than Buildings, 6960/Other Capitalized Leases), not as an operating expense (5000 Object) or as a trustee and benefit payment.

The interest portion will be recorded as an expense to the budget category/STARS object operating expense (subobject 5962), not as capital outlay or trustee and benefit payment.

For budgeting purposes, the agency shall request the principal amount of all capitalized leases in the capital outlay category and the interest portion in the operating expense category. Each subsequent budget year, the principal payment and interest expense for that budget year shall be shown in the replacement capital outlay and replacement operating expense portion of the budget. These requests should indicate the term of each lease and the remaining time to finalization.

The agency shall record the value of the leased asset at either the fair market value or the present value of future minimum lease payments, which ever is less. The agency shall record this either on their own fixed asset system or on the SCO's FAS (Fixed Asset System) using the ownership code of (L).

If the lease involves acquisition of more than one asset, each asset is to be apportioned its share of the total lease value and recorded separately. If at the end of the lease the agency obtains ownership of the asset, they should contact the SCO lease specialist (Reporting and Review) for book value and instructions on updating the asset in FAS from a lease to a capital asset.

For statewide reporting purposes, agencies are required to report capitalized lease information to the State Controller, as requested in the Capitalized Lease GAAP closing package.

RESOURCES

[Click here for a detailed example of a capital lease.](#)

The State Controller's Office has created an MS Excel template for you to help calculate present value. [Click here to open the Excel template.](#) You can then save the template on your computer.